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TO RUEHC/SECSTATE WASHDC IMMEDIATE 0336
INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE IMMEDIATE
RUEHGB/AMEMBASSY BAGHDAD IMMEDIATE 0188

C O N F I D E N T I A L SECTION 01 OF 03 VIENNA 000810

SIPDIS

E.O. 12958: DECL: 06/10/2018
TAGS: ENRG PREL EPET EINV AU
SUBJECT: NABUCCO: MOVING FORWARD ON VARIOUS FRONTS DESPITE HURDLES

REF: A) VIENNA 764 B) VIENNA 209

Classified By: Charges d'Affaires a.i. Scott F. Kilner for reasons 1.4 (b) and (d).

Summary

¶1. (C) In a June 2 meeting with EUR DAS Bryza and Charge, OMV Gas CEO Werner Auli and Nabucco Managing Director Reinhard Mitschek sounded optimistic about the project's progress despite a number of major issues that needed to be solved. Nabucco hopes an end-of-June meeting in Den Haag will produce significant progress on the IGA, including on a transit regime. OMV will soon announce a market sounding in preparation for its open season process. OMV endorsed the idea of a follow-on meeting in September, perhaps in Bucharest, to the February 2007 IEA-sponsored meeting to bring together potential suppliers, the Nabucco Consortium, and the Shah Deniz (SD) Consortium. Auli hoped that SD II would be able to supply Nabucco with 8 bcm for the project's start-up. Russia, according to Auli, will not renew a 6 bcm supply contract with Turkey. Turkey has therefore signaled its interest in purchasing all of SD II, potentially preventing Azeri gas from reaching Europe and discouraging any European investment in Turkmenistan. In an attempt to break the impasse with Ankara over transit, OMV has offered Turkey a "security of supply" clause, which would allow shippers to off-take up to 50% of their gas, at Turkish market prices, in the event of a legitimate supply disruption. Although Turkey continues to insist on a net-back pricing scheme, OMV and Austrian Minister of Economics Martin Bartenstein believe Ankara will eventually agree to Nabucco's proposal.

¶2. (C) Iraq, according to OMV, has the potential to supply Nabucco with 5-6 bcm in the medium-term. However, Turkey appears to favor shipping Iraqi gas to Ceyhan for liquification and export as LNG, a strategy that could lock Iraqi gas out of Nabucco. OMV expressed interest in buying Turkmen gas "at the Turkmen border." DAS Bryza cautioned OMV to be wary of Gazprom's intentions within the Central European Gas Hub joint venture given Gazprom's access to commercial data flowing through Baumgarten. OMV publicly announced the cost of Nabucco had been revised upward to Euro 7.9 billion ($12.2 billion) from Euro 5 billion ($7.8 billion) due to significantly higher steel prices. End Summary.

IGA, Open Season, and IEA Follow-up Meeting

¶3. (C) EUR DAS Matt Bryza, Charge, and EconUnit Chief met on June 2 with OMV Gas CEO Werner Auli and Nabucco Managing Director Reinhard Mitschek to discuss progress on Nabucco, as well as the OMV-Gazprom joint venture on the Central European Gas Hub. Mitschek said that EU Nabucco Coordinator van Aartsen would host a conference for Nabucco countries and

observers the end of June in Den Haag, at which time the IGA could be finalized and the Turkey-Azerbaijan gas transit dispute will be resolved. OMV wanted the conference to take place before the French assume the EU Presidency the second half of 2008, implying that the GoF was still upset about the exclusion of Gaz de France from the consortium. Azerbaijan, according to Mitschek, did not want to attend the conference, stressing that the Turkish transit problem should first be solved.

¶4. (C) Mitschek noted that there are two draft IGAs being circulated: one is a 2-3 page general political statement; the second is a more detailed document, with specifics that the project needs defined, such as financial guarantees, pipeline specifications, terms of transit, etc. Mitschek conceded that the Den Haag conference would be a working session, rather than a signing ceremony, to iron out outstanding issues.

¶5. (C) Mitschek said that OMV would very soon announce a market sounding in preparation for an open season process. Information would soon be sent to an extensive list of possible suppliers, both governmental and commercial. During the second half of 2008, Nabucco hoped to fine tune specifics based on input from the market sounding.

¶6. (C) Auli endorsed the idea of a meeting in September to follow-up the February 2007 IEA-sponsored Southern Corridor Conference. Such a conference would bring together upstream and mid-stream (Nabucco consortium) entities, and most importantly the GOAJ, SOCAR, and the Shah Deniz (SD) Consortium. Auli noted that, by September, Nabucco hoped to

have completed the IGA and a preliminary sounding of potential volumes for its open season. Auli agreed with Bryza's suggestion that Bucharest might be the best location for such a meeting.

Azerbaijan: Who's Marketing the Gas?

¶7. (C) Mitschek lamented that Azerbaijan had "no clear concept how to market its gas." It remained unclear to OMV whether SOCAR or the SD Consortium would market the Azeri gas. OMV, according to Mitschek, made a point of keeping both SOCAR and the consortium in the loop, but, ultimately, there needed to be more clarity about "who is selling the gas."

¶8. (C) Auli suggested that Nabucco could start up with 8 bcm from Azerbaijan. Mitschek noted that OMV had recently met with the SD Consortium to pitch Nabucco as a better potential customer than TGI. With TGI, Mitschek argued, all the gas will go to one buyer (Edison), with no open season, and any progress towards a TCP would be slow. On the other hand, Nabucco would offer the consortium a broader portfolio of markets and the potential for growth when the second phase of Nabucco reaches 31 bcm in 2017-2018.

Allaying Ankara's Supply Concerns

¶9. (C) Recognizing that security of supply was critical to reach a transit agreement with Turkey, OMV had proposed a scheme to the GoT whereby Nabucco shippers would ex ante agree to deliver up to 50% of their gas to Turkey, in the event of a disruption of Turkey's gas supply. The shippers would have to voluntarily agree to this, but Mitschek expressed confidence that most would agree to the arrangement. A disinterested third-party, such as the IEA, would determine what constituted a legitimate supply emergency.

¶10. (C) Turkey, according to Mitschek, continues to insist on a net-back pricing arrangement, something that none of the potential Nabucco shippers are willing to consider. Auli quipped that while Turkey complained about its "difficult neighbors," Turkey might actually be "the difficult neighbor." Despite arduous negotiations with Turkey, Mitschek expressed confidence that Ankara would eventually "come around" to an acceptable transit agreement. Following a recent visit to Turkey, Austrian Minister of Economics Bartenstein also remained optimistic that a transit deal could be signed with Turkey (ref A).

Russia's Strategy to Lock In Caspian Gas

¶11. (C) According to Auli, Russia remained intent on preventing Caspian gas from reaching the European market through a Southern Corridor route, thus enhancing Gazprom's near-monopoly position in Europe. Auli said Turkey had signaled increased interest in purchasing all of Shah Deniz II, following Russia's decision not to renew a 6 bcm delivery contract to Turkey. Without Azeri gas to justify construction of a Southern Corridor pipeline, there would be no incentive for additional western investments to bring Turkmen gas to Europe. If the current political stalemate with Tehran continues, Iranian gas will eventually reach Europe anyway via Russia, Auli predicted. All of this, according to Auli, will play into Russia's plans to torpedo Nabucco and increase reliance on Russian gas through South Stream.

Iraq: Locking Itself Out of Nabucco?

¶12. (C) Turning to Iraq, Mitschek said that Iraq could provide 5-6 bcm to Nabucco over the mid-term. However, Turkey apparently favors shipping Iraqi gas to Ceyhan, then as LNG on to the U.S and the Far East markets. Mitschek maintained that Iraq had previously explicitly agreed to supply Nabucco, potentially via the Arab Gas Pipeline. With Turkey's LNG strategy, there will be no capacity in Nabucco for Iraqi gas. Bryza countered that Iraq had expressed interest at the March 1 U.S.-Iraq-Turkey gas trilateral in exporting its gas at Akkas and in Northern Iraq to Europe via Turkey and Nabucco. Iraq needed a development plan for its gas sector, and the central government and the Kurdish Regional Government needd to settle on a Hydrocarbon Law to

give investors confidence. OMV, Mitschek noted, was in a difficult position with Baghdad, because of the central government's opposition to OMV oil exploration in the Kurdish region (ref B).

OMV Wants to Buy Turkmen Gas

¶13. (C) Auli agreed that Turkmenistan had become a more viable possibility for Nabucco gas for the medium-term, but there were still substantial hurdles to overcome. Auli noted that Turkmenistan's discouragement of foreign investment in on-shore development was not helpful. The possibility of Nabucco had driven up the price Gazprom would pay for Caspian gas, in Auli's view, but if Nabucco fails, the price will fall. OMV was considering offering to buy Turkmen gas "at the border," but it was unsure about GOTX sensitivities and "where the border was." DAS Bryza encouraged OMV to approach the GOTX directly and discretely about this option, adding that the border was "somewhere east of Azerbaijan." Auli said that OMV, or any major, is technically capable of completing the 60-kilometer link between the Turkmen and Azeri off-shore facilities.

How the USG Can Help

¶14. (C) DAS Bryza promised to lend USG support on several issues, which are impeding Nabucco's development: leveraging Turkey to refrain from locking up all the Shah Deniz II gas; pressing Azerbaijan for clarity as to who (SOCAR or the SD Consortium) will market SD II gas; inquiring whether Baku wishes to participate more actively, including attending the June meeting in Den Haag, in the IGA process; and persuading Iraq to earmark some of its future gas to Nabucco.

OMV-Gazprom Joint Venture in Central European Gas Hub
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¶15. (C) DAS Bryza pointed out that there were transparency concerns regarding the possibility that Gazprom could gain access to sensitive commercial data about volumes and prices of gas flowing through Baumgarten. Bryza raised on-going USG concerns about Gazprom's joint venture with OMV in the Central European Gas Hub (CEGH). Gazprom might be able to use the data to create arbitrage possibilities and artificially maintain higher gas prices in Europe.

¶16. (C) As for Gazprom's ability to gain access to commercial data, Auli responded, "the Russians are who they are." Auli opined that Gazprom may already have access to commercial data via other means. He maintained that OMV could ultimately "handle Gazprom."

¶17. (C) Auli said that Russian gas now accounts for 95% of all gas flowing through Baumgarten. He stressed that the CEGH was a trading platform, with OMV maintaining complete control over Baumgarten's infrastructure. OMV, Auli added, hoped to use CEGH to facilitate short-term liquidity on the gas market, transitioning from long-term contracts. Any cooperation with Gazprom on storage facilities in the region would be to create additional capacity, not to replace existing storage.

Nabucco Cost Now Up To Euro 7.9 Billion

¶18. (U) At a May 30 press conference, Mitschek announced that the cost of Nabucco had been revised upward to Euro 7.9 billion ($12.2 billion) from Euro 5 billion ($7.8 billion). Higher crude oil prices had led to significantly higher steel prices, at a moment when there is intense global competition for steel for big projects. Mitschek rejected claims that the higher costs would somehow diminish the project's commercial viability. He pointed out that higher demand for energy would lead to higher gas prices and higher transportation fees, as well as higher costs for the rival South Stream pipeline.

¶19. (U) DAS Bryza cleared this cable.
Kilner